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Westerhout, Ed

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PENSION REFORMS IN THE NETHERLANDS

By

Ed Westerhout

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Pension Reform in the Netherlands

Ed Westerhout¹

Abstract

During the last decade, the Dutch have debated intensively reforming their second-pillar pension scheme. Meanwhile, ten years turned out to be a too short period for pension funds to bring their funding ratios to sound levels, due to among others the worldwide decline of interest rates. Currently, the Dutch government and the social partners have come up with a quite concrete reform plan. The plan includes three main points: i) make the move towards actuarially fair pension accruals, ii) strengthen the link between benefit levels and capital market rates of return and iii) introduce the option to take up part of accrued pension wealth at retirement. This paper reviews and interprets the plan for pension reform.

¹ The author is affiliated with the department Tax Economics at Tilburg University, CPB Netherlands Bureau for Economic Policy Analysis and Netspar. The views in this paper are strictly personal and cannot be ascribed to any of these institutes.

1. Introduction

The Dutch pension scheme is seen as one of the best in the world. It even ranks number 1 in the latest edition of the Melbourne Mercer Global Pension Index that covered the pension schemes of 37 countries (Monash Centre for Financial Studies, 2019). The focus of the Dutch scheme on collective, obligatory elements and the generous pension benefits it provides seem to be highly appreciated. This top position is a little difficult to reconcile with the ongoing debate about reform of the second-pillar pension scheme in the Netherlands, however. This debate started in 2009 and still has not finished. In fact, whereas in 2009 the committee of pension experts proposed pension reform because of population ageing (Commissie Toekomstbestendigheid Aanvullende Pensioenregelingen, 2010), currently the debate also includes issues like transparency, flexibility, connection to the labour market and vulnerability to changing interest rates.

Attempting to bring the debate to an end, the current administration (Rutte-III) announced a fundamental reform of the Dutch second-pillar pension scheme in its 2017 coalition agreement (Ministerie van SZW, 2019a). Based on this agreement, the government and the social partners concluded about pension reform in their *Pensioenakkoord* of June 2019 (Ministerie van SZW, 2019b). In particular, the latter agreement focuses on three points: i) make the move towards actuarially fair pension accruals, ii) strengthen the link between benefit levels and capital market rates of return and iii) introduce the option to take up part of accrued pension wealth at retirement.

This paper reviews the current Dutch pension debate, focussing on what I perceive to be the key issues. That means the review will not be exhaustive. In particular, the review excludes those issues on which no concrete proposals exist.² Furthermore, the review focuses on the second pillar. Hence, I will only briefly go into the debate on the first-pillar pension eligibility age.³

This paper is structured as follows. Section 2 provides some institutional background. Section 3 reviews the key issues in the Dutch pension debate. Section 4 then discusses the reforms as proposed in the *Pensioenakkoord*. Section 5 concludes.

2. Dutch pension institutions

As a background, this section sketches the main features of the Dutch three-pillar scheme and of its second pillar, the scheme of (semi-) obligatory supplementary pensions.

² Examples are the so-called *rekenrente* (the discount rate that pension funds are required to adopt for the calculation of their pension liabilities), the lack of freedom for many salary workers to opt out of their pension scheme or to choose between pension funds, and the balance between pay-as-you-go (PAYG) and funding in financing pensions.

³ The main issues are the link between future increases in life expectancy and the pension eligibility age and the differentiation of the pension eligibility age between different groups of workers.

2.1. The Dutch three-pillar scheme

The Dutch pension scheme can be characterized as a three-pillar scheme.⁴ The first pillar, the AOW scheme, provides a basic pension. The AOW is a general type of insurance that provides all citizens a life-long pension starting at the retirement date. Benefits are income-independent and not means-tested, but their level depends on how many years the recipient has resided in the Netherlands. The second pillar concerns (semi-)obligatory supplementary pensions. They cover the employees of firms within a sector (industry-wide pension funds), the employees of a specific firm (company pension funds) or workers that have the same kind of job (occupational pension funds). Benefits depend upon individual contributions, but the financial position of the fund plays also a role. The third pillar concerns voluntary supplementary pensions. These pensions are arranged on an individual, voluntary basis.

The three pillars differ in financing principle and in their coverage. As regards financing, the first-pillar scheme is based on PAYG; second and third-pillar contracts rely on funding. As regards coverage, the coverage of the first-pillar scheme is complete; every resident participates in the scheme on a compulsory basis. The third pillar is the opposite: participation is voluntary and only a relatively small number of people participate. The second pillar is in between. If social partners have decided to arrange a contract, workers are obliged to participate. But this coverage, although large, is not 100 percent. The self-employed and part of salary workers do not participate in a second-pillar contract for reasons we will describe below.

The share of the first pillar in retirement income is 57 percent and that of the second pillar is 39 percent. The role of the first pillar is thus somewhat smaller than in a number of other countries (OECD, 2016). The role of the third pillar has always been relatively modest.

Pension benefits are quite generous. In its most recent review, the OECD calculates that the average gross replacement rate in the OECD area equals 53 percent (OECD, 2017). The Netherlands stand out with an average replacement rate of no less than 97 percent. This picture applies not only to people with average income. In the OECD area, the replacement rates for people with half or one and a half times average wage income are 65 and 48 percent respectively; in the Netherlands the corresponding figures are 98 and 97 percent.

In 2012, the Dutch government decided to gradually increase the age at which people start collecting AOW benefits. In the period in between 2012 and 2022, the retirement age would increase from 65 to 67 years and three months. From 2022 onwards, the retirement age would further increase in line with life expectancy at the age of 65 such that the period during which people live in retirement would no longer expand. Since then, the rules governing the increase of the AOW eligibility age have been modified two times, but the basic idea of increasing the AOW eligibility age in two steps (first, unconditionally and later conditional on the development of life expectancy) still stands.

2.2. The second pillar

The Dutch second-pillar scheme features a variety of contracts, among which are final wage defined benefit (DB) contracts, average wage DB contracts and defined contribution (DC) contracts. The average wage DB scheme is by far the most important contract, holding a market share of 91.8 percent (DNB, 2018a). The final wage DB contracts and the DC contracts have market shares of 0.2

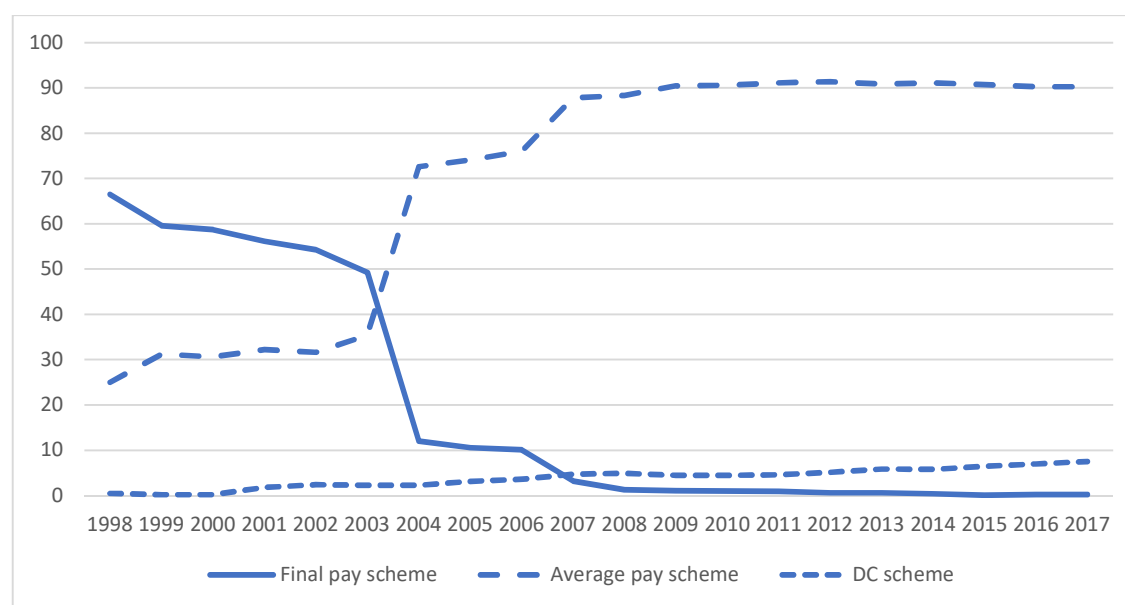
⁴ Internationally, it is more common to distinguish between five pillars (World Bank, 2005). That does not mean that five pillars can be found in all countries, however.

percent and 8.0 percent respectively. In the following, we will therefore focus mainly on the average wage DB pension contract.

The dominance of the average wage DB contract is a recent phenomenon. In the year 2000, at the brink of the “dotcom” crisis, the market share of this contract was only 30.5 percent, whereas the final wage DB contract held a share of about 59 percent. Figure 1 illustrates the dramatic change from final wage DB contracts into average wage DB contracts that has taken place in only a few years. The figure also shows the growing importance of the DC contract.

Before we continue, a caveat on the terminology used is in place, however. Although officially labelled a DB contract, the benefit of the average wage DB contract is by no means defined. In most cases, indexation is only conditional, *i.e.* pension funds index the benefits they provide against inflation if financial circumstances are deemed sufficiently good. Indeed, indexation has been (far) less than 100 percent for many years, as we will see below. In addition, some pension funds pursue stable contribution rate policies. Therefore, the term collective defined contribution (CDC) contract would be more appropriate.

Figure 1: Market share of different contract types in the second pillar



Source: DNB (2018a, 2018b)

Note: The data up to 2006 do not match with those from 2007 onwards.

Funding

The financing of second-pillar pensions is based on funding. Given the large role of the second pillar in the Netherlands, Dutch pension funds hold huge amounts of financial wealth. Indeed, in 2017 the combined pension wealth of these pension funds amounted to a little more than 1450 billion euro,

almost 2 times Dutch GDP.⁵ The major investment category is equity and participations, amounting to 934 billion euro at that time, or 64 percent of financial wealth.

Coverage

As indicated above, the arrangements for supplementary pensions are semi-obligatory. If offered a pension contract by their firm, workers are obliged to participate. Still, there are workers who do not participate in a second-pillar pension contract. One reason is that some firms are not covered by an industry-wide arrangement or an occupational arrangement; another reason is that some firms choose not to offer their workers a pension contract, because this is deemed too costly or because they do not fully trust the pension sector. There are also firms that offer a pension contract only to part of their work force. The most recent investigation concluded that about 13 percent of salary workers (about 850 thousand persons) do not participate in a pension contract (Ministerie van SZW, 2018). This estimate is much higher than the previous estimate as of 2016, which was 4%. In addition, the last ten years have featured a spectacular increase in the number of self-employed, up to a number of about 1.4 million persons in 2017 (CBS, 2018). These self-employed persons are not covered by second-pillar schemes at all, except if they have been salary workers before they became self-employed and if they had the opportunity to stay with their previous pension scheme. A recent investigation estimated that about 200 thousand self-employed persons do not accumulate any second-pillar pensions at all (Ministerie van SZW, 2018).

Governance

The governance of Dutch supplementary pensions is complicated. In theory, the allocation of powers is pretty straightforward. Social partners, *i.e.* workers and employers, decide on the form and content of second-pillar arrangements, whereas the government decides on the applicable fiscal framework. The Dutch Central Bank and the Financial Market Authority supervise pension funds, on their financial economic policies and their communication with participants respectively. In practice, the allocation of powers is more blurred, however. Typically, (sometimes lengthy) consultation of trade unions and employee organisations precedes any decision-making by the government. The so-called *polder model* in the Netherlands aims at achieving consensus among all parties involved before any policy reform is undertaken. Consequently, policy reform can be a lengthy process if there are many stakeholders with different interests involved; the ongoing pension debate is a vivid illustration of this.

Collectivity

The collective nature of the average wage based DB scheme implies redistribution between persons with different characteristics. Hence, as will be discussed in more detail below, collective schemes imply redistribution from young to old workers, from the low-educated to the high-educated and from males to females.

⁵ 2017 GDP amounted to 734 billion euro.

Funding ratio

Financial, economic and demographic shocks almost continuously change the funding ratio of pension funds (financial wealth of the pension fund in terms of total current and future obligations). Traditionally, funds used the pension contribution rate to absorb these changes. Given that the workforce has declined as compared to the group of retired persons and pension contribution rates are currently quite high, funds nowadays rely less on this instrument. Instead, they now rely more on indexation cuts, which is due to the fact that the transformation from final wage DB schemes to average wage DB schemes, as discussed above, greatly enhanced the effectiveness of indexation policies. Indeed, in the case of average wage DB schemes, cuts in indexation apply not only to paid out pensions, but also to pension rights. Indexation cuts have in general been insufficient to restore funding ratios to previous levels, however, for two reasons: low price inflation and a dramatic decline of interest rates. We will discuss these in somewhat more detail in the next section.

As pension funds are allowed to take long periods to restore funding ratios, their policies imply also risk sharing between current and future generations. Note that this risk sharing is in principle a two-sided process. Future generations can make implicit transfers to current generations to absorb adverse shocks, but can also receive implicit transfers from current generations in case of positive shocks. However, since 2009 the average real funding ratio has been below 100 percent. Therefore, since then risk sharing between current and future generations has been more of a one-sided process.

Flexibility

The supplementary pension arrangements feature little flexibility. As mentioned above, in most cases a worker is obliged to participate in the pension arrangement to which his or her firm is connected. A worker cannot decide how his or her contributions are invested. Furthermore, there is no flexibility as regards the accrual of pension benefits. As to the pay-out phase, there is some flexibility. Participants can choose a two-step profile for their pension benefits.⁶ They can also choose to advance or delay their pension pay-out phase. In both cases, the level of the pension benefit is actuarially adjusted. There is no flexibility as regards the type of pay-out, however. Pensions must be paid out on an annuity basis; lumpsum pay-outs are not allowed. On this point, the Netherlands deviate strongly from what is common internationally (García-Huíttron and Ponds, 2016).

3. Issues

As indicated above, the prospect of population ageing sparked the debate about pension reform. The financial shock in 2008 added fuel to this debate. The impact of this shock is clearly visible in the (development of the) funding ratio of pension funds. As figure 2 makes clear, the development of the funding ratio is remarkable in two ways: the sharp decline in 2008 and the subsequent stabilization on a much lower level for about a decade.

⁶ There are restrictions, however. First, the ratio between the benefits in the first and second step is not allowed to exceed 100:75. Second, the first step should last between 5 and 10 years.

3.1. The collective nature of the pension contract

The worldwide crash of equity markets in 2008 was the primary reason for the decline of the funding ratios of pension funds. Additionally, a series of increases in longevity contributed to this development. Next, the subsequent decline of interest rates exercised an important effect. The reason is that as Dutch pension funds strive to guarantee pension benefits, the supervisor requires them to use a market-based risk-free rate to discount their liabilities.⁷ This risk-free rate fell sharply to a level of 1.6 percent for bonds with a maturity of 20 years. Consequently, pension liabilities increased markedly. This does not apply to all pension funds to the same extent, however. There is great variety across pension funds, depending among others on their portfolio share of equity and their hedging of interest rate risks (OECD, 2010).

The ongoing decline in interest rates explains why Dutch pension funds have not been able to bring back their funding ratios to pre-2008 levels. Pension funds invest huge amounts in equity and equity returns have been quite positive in a number of years. The increase in pension wealth that has resulted from this was insufficient to improve funding ratios however as the decline of interest rates increased pension liabilities significantly. To put it in numbers, the financial wealth of pension funds grew at an annual rate of 6.4 percent, that is, from 779 EUR billion in 2007 to 1453 EUR billion in 2017. In the same period, aggregate pension liabilities increased from 541 EUR billion in 2007 to 1333 EUR billion in 2017, which amounts to an annual growth of 9.4 percent. As a result, the average funding ratio declined from 144 percent in 2007 to 109 percent in 2017.

Figure 2: Average funding ratio of pension funds

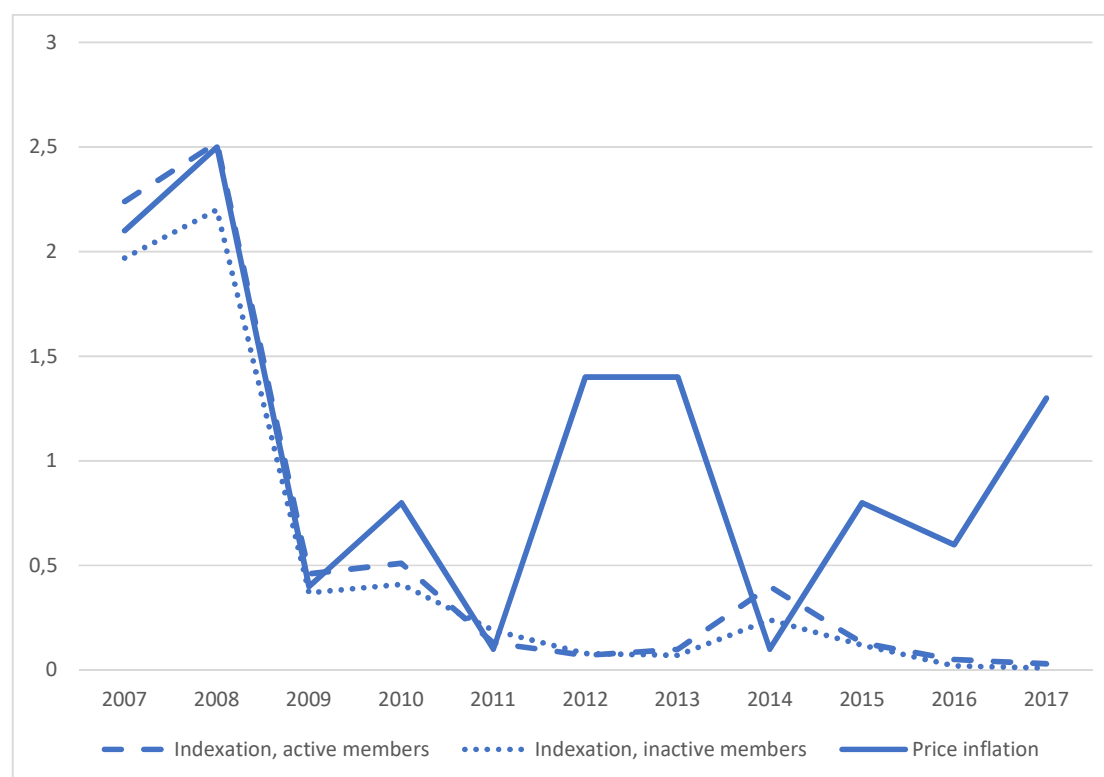


Source: DNB (2018d)

⁷ For a long period of time, the Netherlands used a 4 percent rate to discount future pension liabilities. This changed in 2007, when the Pension Law was renewed and a Financial Assessment Framework was introduced.

As mentioned above, in the same period price inflation has been relatively low. Hence, even a complete elimination of indexation would have been insufficient to bring back funding ratios to their pre-2008 levels.

Figure 3: Indexation of pensions by pension funds



Source: DNB (2018c), CPB (2018a)

Pension funds reacted basically in three ways upon the deterioration of their financial position. First, they raised pension contributions. In the 2007-2017 period, the average pension contribution per worker increased with 25 percent (DNB, 2018a). Second, pension funds reduced the indexation of pension benefits to almost zero (see figure 3).⁸ To make it concrete, in the 2007-2017 period pensions increased on account of indexation with 6.3 percent. The cumulative rate of price inflation in this period amounted to 12.1 percent. Hence, in real terms pensions declined more than 6 percent on account of lost indexation.⁹ On top of that, some funds were required to cut their pensions in

⁸ Pension funds apply so-called indexation ladders which relate the indexation of pensions to their funding ratios. Globally speaking, these indexation ladders imply zero indexation to a funding ratio below 110 percent (funds are not allowed to index their pensions when their funding ratio is below 110 percent since the adjustment of the Financial Assessment Framework in 2015), imply full indexation when the funding ratio exceeds 130 percent and imply a linear relation between the degree of indexation and the funding ratio when the ratio is between 110 and 130 percent.

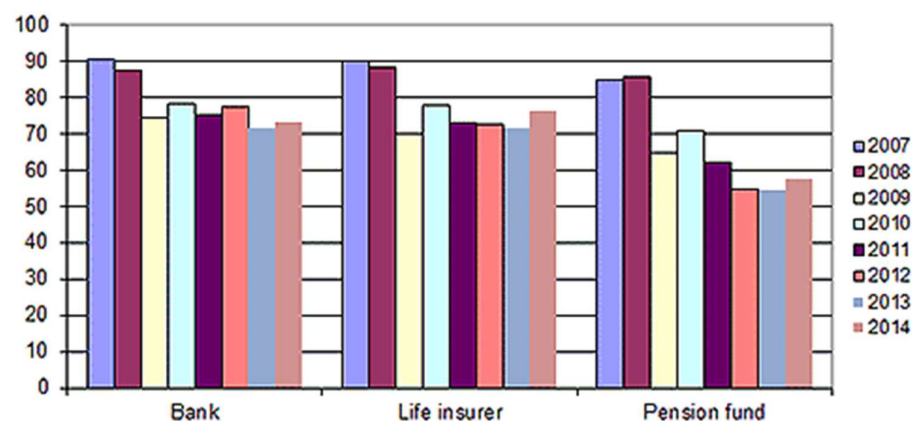
⁹ As shown in figure 3, the indexation of pension rights (indexation of active members) was slightly higher: 5.3 rather than 6.3 percent.

2013.^{10,11} On average, the cut was 1.0 percent for about one third of the participants in pension plans. Taken together, the average decline of pensions was about 6.6 percent in real terms.

Two qualifications should be made to this outcome however. The AOW makes up about half of a full pension (the sum of the first-pillar and the second-pillar pension). AOW benefits have been fully indexed in this same period. Accounting for this roughly halves the aggregate loss of purchasing power of pensions and tilts the largest losses to those for whom the second-pillar pension is relatively important. In general, these will be people with higher than average incomes. On the other hand, differences between pension funds are huge. At the individual level therefore, losses for those who happen to be member of the financially least healthy pension funds can greatly exceed the average loss.

Yet, public confidence in pension funds declined very strongly. Figure 4, taken from DNB (2014), presents the results of surveys about the confidence that people have in their pension funds. The indicator of the public confidence fell from 85 percent in 2007 to a level of 57 percent in 2014. The confidence in other financial institutes like banks also fell, but less markedly, which can be considered remarkable given the role of banks in the Great Recession.

Figure 4: Confidence in own bank, life insurer or pension fund



Source: DNB (2014)

Table 1 adopts a broader perspective by focussing on a longer period and by also including trust in the government. The figures in this table confirm those in figure 4: the trust in pension funds declined, both in absolute terms and relative to the trust in other institutions.

¹⁰ Before 2015, the Financial Assessment Framework stipulated that a pension fund has to curtail its pensions if it is to be expected that the fund cannot reach its target funding ratio on account of other policy measures in a period of 3 years (5 years in 2008). Since 2015, a similar rule applies, but with a term of 10 rather than 3 years. In addition, since 2015 a pension fund has to curtail its pensions also if its funding ratio has been below a minimum value for 5 consecutive years.

¹¹ 75 pension funds curtailed pensions in the 2008-2012 period. Basically, the cuts applied in 2012 materialized in 2013 (DNB, 2013).

Table 1: Trust in financial institutions, 2004-2014 (percentage of the general population who (very much) trust specific institutions)

	2004	2006	2009	2011	2014
Pension funds	53	64	44	42	48
Banks	32	37	25	34	30
Insurance companies			18	20	25
Government	37	42	45	41	41

Source: Van Dalen and Henkens (2018)

How can we explain this abrupt decline of trust in pension funds? One might point to earlier expectations. Expectations of pension benefits may have been overoptimistic, fuelled by a long history of indexation to price inflation. Hence, if benefits in real terms turn out to be lower than expected, participants may have perceived this as a loss. That earlier expectations are important is also a lesson from prospect theory, according to which people derive utility not so much from income itself but more from income in relation to some sort of reference income. In addition, the cuts in nominal pensions that some pension funds were required to apply, may have contributed to the decline of trust. These cuts made clear to everybody what was known by only a few before the cuts: nominal pensions are not guaranteed unconditionally. Money illusion may have further aggravated the impact of the nominal cuts.

The development of the average funding ratio as depicted in figure 2 illustrates risk sharing between current and future generations. Future generations absorb part of the shocks that current generations would have had to absorb completely if the pension scheme would have been individual rather than collective. Many see this risk sharing between generations as one of the corner stones of collective pension systems (Barr, 2012). From an ex ante perspective, this risk sharing is generally welfare-increasing as long as risk sharing implies (implicit) transfers from generations with low marginal utility of income to those with high marginal utility of income. The result even holds true when adverse effect upon the labour market are taken into account (Bonenkamp and Westerhout, 2014). Westerhout *et al.* (2016) estimate the welfare gain from risk sharing to be equivalent to a 0.2 percent increase in lifetime consumption. There is little agreement among researchers about the exact value however (Boeijen *et al.*, 2016).

The nominal pension cuts that were implemented in 2013 triggered the adjustment of the Financial Assessment Framework in 2015. By lengthening the recovery period for pension funds, this adjustment increased the scope for risk sharing with future generations. According to expressions in the media, it seems the principle of risk sharing is not well appreciated, however. Current generations and especially the old, who are benefiting from this risk sharing, seem to consider themselves as net contributors rather than net recipients. Imperfect knowledge about concepts as risk and risk sharing may play a role here.

3.2. Uniformity pricing

The collective average wage based DB scheme features uniformity pricing: the contribution rate and the accrual rate are independent of the age or other characteristics of participants. This gives rise to at least four issues: redistribution between workers of different age, redistribution between groups

with different life expectancies, lower or higher labour market participation and a low implicit rate of return on contributions to the pension scheme.

Why does the principle of uniformity pricing imply redistribution between young and old workers? The contributions paid by young employees yield a higher pension benefit than those paid by old employees as they are invested for a longer period. The accrual of pension rights is the same for the two groups, however.¹² Hence, uniformity pricing implies implicit transfers from young to old workers. In old times, in which it was common for workers to have a lifetime employment with one employer, this was little problematic. Over the lifecycle, transfers received and paid globally cancelled against each other. Currently, labour markets are more dynamic and employer-employee relations more short-lived, however. Hence, more often than before transfers paid over the lifecycle do not cancel against transfers received. Many therefore consider the principle of uniformity pricing as unfair.

The issue is illustrated most dramatically by the case of a person who has been a salary worker until the age of, say, 45, and who then continues as a self-employed person. This person pays implicit taxes (defined as pension contributions minus accruals), but will not enjoy any implicit subsidies (defined as pension accruals minus contributions) in return. For persons who change from salary worker to self-employed at an earlier or later date, the problem is less severe. The same holds true in case people move from one pension scheme to another because of a switch in job. But in all cases, a job switch will generally involve implicit transfers (negative or positive).

Uniformity pricing may also affect labour mobility. Particularly, it may withhold middle-aged salary workers to become self-employed, for if they do, they will lose a bulk of implicit subsidies to labour income. This argument may not be particularly relevant, however. There is less rationality than assumed in classic economic theory, especially in the field of pensions where decision horizons are very long. Dutch data point in the same direction. In a period of ten years in which the system of uniformity pricing did not undergo any change, the number of self-employed people increased dramatically (see the previous section). Although this cannot be considered strong evidence, it does suggest that the impact of uniformity pricing upon labour mobility is not extremely large. Related to this, the possibility to transfer pension rights in case of a job switch is a complex one. But, as noted by OECD (2010), it is questionable whether this will have significant effects on the labour mobility between sectors and firms.

As regards the second issue, it is rather obvious that the principle of uniformity pricing implies redistribution between groups with different life expectancies. Compare two persons who have the same income but different life expectancies. The two persons pay the same amount of pension contributions, but the person with longest life expectancy can expect to receive pension benefits over a longer time period. Now, it is well-known that life expectancy of the high-educated is higher than that of low-educated persons (Cutler *et al.*, 2008). Hence, uniformity pricing implies redistribution from the low-educated to the high-educated (Bonenkamp, 2009). For a similar reason, pension schemes imply redistribution from males to females.

¹² In case of indexation, the argument must be qualified. Suppose for the sake of the argument that there is full indexation against wage inflation. The rate of return on accruals now equals the rate of wage or productivity growth. Hence, pension contributions will be front-loaded only if the capital market rate of return exceeds the rate of productivity growth. In practice, this will often indeed be the case. Indeed, dynamic efficiency implies that the condition will hold true. If benefits are only partly indexed against wage inflation or if benefits are indexed against price inflation, it is even more likely that pension contributions are front-loaded.

The third issue concerns labour market participation. The implicit taxes paid by young workers and the implicit subsidies received by old workers may induce the two groups of workers to change their number of hours worked. Particularly, the young may reduce their number of hours worked, whereas for old workers the opposite may hold true. There is some empirical evidence that the labour supply of older workers is more price-elastic (Fenge *et al.*, 2006). Hence, uniformity pricing may contribute to a higher level of labour market participation at the aggregate level. If young workers pay less attention to their pension than older workers do, as suggested by population surveys, this argument is even strengthened.

That uniformity pricing implies a low implicit rate of return relates again to the front-loaded nature of pension contributions. For it means that part of the pension contributions paid by young workers are actually used to finance the pension rights of older workers. Stated differently, because of uniformity pricing, part of the pensions is pay-as-you-go financed. If the economy is dynamically efficient, pay-as-you-go financing implies a lower rate of return than funding. As a consequence, uniformity pricing results in a lower rate of return than could be achieved in a comparable scheme without uniformity pricing.

3.3.A lack of flexibility

As mentioned in the previous section, the average wage based DB scheme features little flexibility. A person who has decided to become salary worker has little decisive power as to whether to participate or not in a pension arrangement, which pension fund will carry out the arrangement, how the accumulated funds are invested and when and in what form the accrued wealth will eventually be paid out. For the self-employed, a different story holds true. More on this below.

The uniform setup is surely advantageous. Operating costs can be held low. Illustrative is the ranking of selected OECD countries in terms of operating costs as a percentage of total investment. The Netherlands has costs of only 0.1 percent, whereas these costs range from 0.1 to 1.5 percent in the countries reviewed (OECD, 2017). Lacking competition, there is no need for funds to spend on marketing. In addition, many workers seem to like that they do not need to be involved in financial decisions themselves. Indeed, surveys typically find that most people like to delegate complex financial decisions to a pension fund.

On the other hand, there is also a group of people who would like to exercise more discretion in their financial life-cycle planning. Particularly popular is the idea of a lumpsum pay-out at retirement. Recently, three surveys have been conducted among the Dutch that showed much enthusiasm for a limited lumpsum at retirement date.¹³ The surveys should be taken with care as their results differ quite a lot. In addition, the idea that a significant fraction of pension participants is interested in a more flexible pay-out is difficult to reconcile with the fact that only a small fraction of participants makes use of options that are already available (such as to forward part of the lifetime pension benefits by taking up a somewhat higher pension in the first years following retirement).

¹³ A survey under the participants of ABP, the largest pension fund in the Netherlands, finds that 58 percent of those questioned would like to have the option to take up a lumpsum at retirement that equals 20 percent of accumulated pension wealth (Bockweg *et al.*, 2016). The results of a survey conducted by PGGM were similar: 30 percent of those questioned would prefer a lumpsum payment (Willemsen and Kortleve, 2016). A third survey indicated that only 12 percent of the respondents would be interested in a partial lumpsum at retirement, however (Van der Crujssen and Jonker, 2016).

Introducing the possibility of a lumpsum might then be a promising idea. The many participants who feel comfortable delegating decision-making to their pension funds could choose not to use the possibility. Those who feel constrained by the current lack of flexibility could choose to take up the lumpsum. There is also a downside. More discretion may induce individual participants to front-load their consumption more than is warranted, forcing people into poverty at old age or forcing the government to bail them out. According to WRR (2017), not only low educated, but also high educated people suffer from a lack of discipline in financial decision-making.

Two recent studies compare the welfare gains and costs of more flexibility in the pension scheme. Van Ewijk *et al.* (2017) signals that the costs of errors in financial decision-making may be prohibitively high. Folmer *et al.* (2018) concludes that the welfare costs of a small lumpsum may be an order of magnitude smaller than the gains of more flexibility at the individual level. The difference between the two studies is in the modelling of the behaviour of those who make financial errors in their financial decision-making. Van Ewijk *et al.* (2017) focuses on the most extreme cases, whereas Folmer *et al.* (2018) describes the likely behaviour of the larger group of people who tend to make errors, large or small.

3.4. Salary workers and the self-employed

Currently, there is a dichotomy between the position of salary workers and that of the self-employed. Apart from some exceptions, salary workers are obliged to participate in a pension contract. This can be motivated from a paternalistic angle: without the government's help, individual workers are deemed unable to make a proper financial planning and to behave according to this planning. The self-employed, on the other hand, cannot participate in the pension funds in which salary workers participate. This can also be given a motivation. Self-employment is considered to be a deliberate choice, so that the government does not need to take care of the self-employed in the same way as it takes care of the salary workers.

The problem with this view is that it considers salary workers and self-employed persons as two very distinct groups. This is not very realistic, as is illustrated by the large group of people who are salary workers in the beginning of their career and self-employed in a later stage. It is also illustrated by the large group of self-employed persons who do not participate in any pension scheme (Ministerie van SZW, 2018). A uniform treatment of the two groups whereby both would be obligatorily insured, would avoid the problem of underinsurance of the self-employed, enlarge the solidarity in the pension system and broaden the scope for intergenerational risk sharing.

4. The proposed reform

As mentioned in the introduction, the June 2019 *Pensioenakkoord* aims at reforming the scheme of supplementary pensions along three dimensions: end uniformity pricing, strengthen the link between benefit levels and capital market rates of return and introduce the possibility to take up part of the accrued pension wealth as a lumpsum at retirement.

4.1. Ending uniformity pricing

The *Pensioenakkoord* proposes to end uniformity pricing by moving to a scheme of degressive accruals. As discussed in the previous section, this will end or at least reduce the implicit transfers between young and old workers. It will also reduce the losses that people have to bear if they lose their job as a salary worker and become self-employed in the middle of their job career. The proposed reform may imply greater transparency at the individual level. However, it will leave intact the redistribution that is taking place between groups with different life expectancies.

As explored in the previous section, uniformity pricing makes it financially attractive to postpone retirement. Ending uniformity pricing will thus create an incentive to old workers to retire earlier, for example through the route of part-time pension or otherwise. This effect can be undone by taking additional policy measures. One can think of the introduction of new labour market subsidies for old workers. In that case, ending uniformity pricing boils down to replacing implicit subsidies to old workers provided through the pension scheme with explicit subsidies provided through the tax scheme.

The great obstacle is the compensation of current workers, however. As we noticed in the previous section, contributions frontload pension accruals. Hence, a blunt introduction of a scheme of degressive accruals would mean that current workers will forego the accrual of pension rights for which they already made a contribution. Many take it as fair that these workers will be compensated. On the other hand, it may be prohibitively costly to aim at providing full compensation at the individual level, whereas it is doubtful whether the associated benefits will be fully perceived by the workers concerned. The big question is who is going to pay for it (CPB, 2018b). From a theoretical angle, one could argue that future workers should pay for it, since they are the ones who will benefit from the increased rate of return in the pension scheme.¹⁴ To put this in practice is much more difficult, as benefits and costs depend on many parameters that differ between participants and that are partly unknown. In its February letter, the government has announced that social partners in all sectors of industry should come up with compensation schemes, to be improved and supervised by the authorities. How this will work out is unclear at the moment of writing. One can only hope that the solution will be transparency and efficient. Transparency is required if one wants to win back the trust of people in the pension system (IMF, 2019). Efficiency is required in order to ensure that the net efficiency gain from the reform will be positive.

4.2. Towards a scheme with individual and collective elements

The second reform element in the coalition agreement involves the move towards a scheme that links benefit levels to capital market rates of return. It is unclear at this moment which concrete form such a scheme will have. Two issues are at stake.

One is the inconsistency between the guaranteed nature of pension benefits and the investment policies of pension funds. Given that pension funds guarantee their members nominal benefits, one would expect them to invest at least the value of their liabilities in nominal bonds. In practice however, huge amounts of pension wealth are invested in equity and real estate. Given the volatility of these markets, one could have predicted in advance that at some point in time pension promises would be broken. Obviously, once participants are aware that benefits may turn out higher or lower

¹⁴ Sinn (2000) shows that in a stylized world the gains for future workers and losses borne by current workers cancel exactly against each other.

than previously expected, the inconsistency disappears. This will require at least that pension funds communicate with their participants that pensions are a financial product which is subject to financial risks. The requirement, introduced in 2019, that pension funds communicate on an annual basis with their participants three different scenarios for benefits (an expected scenario, an optimistic scenario and a pessimistic scenario), is a step in the right direction, although it may take a long time to change the mindsets of all participants.

The second issue is related. The *Pensioenakkoord* states that in the future pension scheme the level of benefits will be more directly related to financial market outcomes. This implies that it reduces the scope for risk sharing between generations. It also implies that the buffers that pension funds are required to have to cushion shocks, can be reduced. The challenge that policymakers now face is to ensure that the relation between financial market outcomes and benefit levels will be made explicit. If parties do not commit to an explicit rule or if this rule is subject to political risk, one may expect that the change in benefit rules will not be credible and not materialize.

4.3. Introducing more flexibility in the pay-out phase

The *Pensioenakkoord* announces that it will be made possible in the future that participants take up 10 percent of their accrued pension wealth at retirement. Compared with the proposals to move to a scheme of degressive accruals and to make benefits more flexible, the proposal to introduce more flexibility seems to be less controversial. This may have to do with the voluntary element. If implemented, participants *can* use the new option; they are not enforced to do so. Furthermore, the fact that 10 percent of accumulated wealth is a quite modest change with current practice, may play a role here as well.

5. Concluding remarks

We conclude by making two observations. The first is that the three reforms as proposed by the government share a common feature. All three concern a move away from a collective approach towards a more individual approach. This fits into a more general international trend in which (individual) defined contribution schemes are expanding and pension eligibility ages are increasing. This in turn bears a close link to worldwide trends of populations becoming older and labor markets becoming more dynamic (Bonenkamp *et al.*, 2017).

The second observation relates to the point at which we started. The reforms envisaged change the way that risks affect pension outcomes, but cannot reduce these risks. If pension participants fail in general to understand this basic logic, they may expect more from these reforms than can be considered realistic. It would be very helpful if the government could find a way to improve general knowledge about pensions. If not, it is possible that many will perceive the pension reforms as disappointing. In that case, the pension debate may not end, but only enter the next phase.

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